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February 8, 2002

MEMORANDUM

TO: Dave Smith
Cathie Fisher

FROM: Jim Doty
Joanne Rutkowski
Niki Kuckes
Sam Waldon

RE: Status of Matters Following D.C. Circuit's Decision in NRECA v. SEC

This memorandum is submitted on behalf of American Electric Power Company, Inc. to address the status of matters before the Securities and Exchange Commission following the January 18, 2002, decision of the United States Court of Appeals for the District of Columbia Circuit in National Rural Electric Cooperative Association v. SEC, No. 00-1371 (D.C. Cir.). As explained more fully herein, it is our view that, pending Commission action on remand, AEP and its subsidiary companies continue to be members of a registered holding-company system under the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79a, *et seq.* (the "1935 Act" or "Act") and, entitled as such, to proceed with the ordinary course of their duly-authorized businesses.

Background

In the NRECA v. SEC decision, the Court was reviewing the Commission's order approving the acquisition by American Electric Power Company, Inc. ("AEP") of the securities of Central and South West Corporation ("CSW") and related transactions under the 1935 Act (the "Order").[1]

[1] Specifically, the Order authorized: (i) the indirect acquisition of CSW; (ii) the acquisition of CSW Credit, Inc.; (iii) certain intrasystem financing transactions; (iv) the consolidation of the nonutility businesses of AEP and CSW; (v) the merger of the CSW subsidiary service company with American Electric Power Service Corporation ("AEP Service") with AEP Service as the surviving entity succeeding to certain authority of the CSW service company; (vi) CSW to distribute or pay as a dividend to AEP the common stock of one or more nonutility subsidiaries; (vii) AEP to use the proceeds of certain financings to invest an amount equal to 100% of the combined system's consolidated retained earnings in exempt wholesale generators and foreign utility companies and (ix) certain actions with respect to stock-based benefits plans maintained by CSW and AEP.

The Order went into immediate effect on June 14, 2000 and, pursuant to the Order, the merger was completed on June 15, 2000. Although a petition for judicial review was filed challenging the Order, the petitioners did not seek a stay and so, AEP and its subsidiaries have continued to operate as members of a registered holding-company system under the 1935 Act.

As noted, the D.C. Circuit issued its decision approximately eighteen months after completion of the merger, on January 18, 2002. In that decision, the D.C. Circuit upheld the Commission's central determination that the merger would produce net "economies and efficiencies." NRECA v. SEC at 16. At the same time, the Court found that the Commission had failed to "provide a satisfactory explanation" in the Order for its determination that the proposed merger met the interconnection requirements of the Act, id. at 12, and had "failed to make any evidentiary findings" or to engage in the proper legal analysis to support its conclusion that the resulting system would operate in a "single area or region," id. at 13. Based on these conclusions, the Court vacated the Order and "remanded for further proceedings consistent with this opinion." Id. at 17.

Effect of the Court's Decision

Under the 1935 Act, and general principles of administrative law, the D.C. Circuit's decision to vacate and remand for a fuller explanation by the Commission of its reasons for approving the merger is intended to give the Commission an opportunity to provide a fuller explanation of its rationale. This is consistent with established principles of administrative law. In SEC v. Chenery, 318 U.S. 80 (1943), a seminal administrative law case decided under the 1935 Act, the Supreme Court established that where a court has found the agency's explanation of its rationale to be inadequate, rather than impute a rationale to the agency, the proper course for the court is to "remand to the Commission for such further proceedings . . . as may be appropriate." Id. at 95; see also City of New Orleans v. SEC, 969 F.2d 1163 (D.C. Cir. 1992) (remanding 1935 Act matter for further development of the record concerning the methodology used to support the Commission's conclusions and the effect of future replacement costs for transferred generation); Cajun Electric Power Cooperative, Inc. v. SEC, 1994 WL 704047 (D.C. Cir. 1994) (remanding 1935 Act matter to allow the commission to supplement or modify its record with respect to effect on competition of subject merger); Wisconsin's Environmental Decade, Inc. v. SEC, 882 F.2d 523 (D.C. Cir. 1989) (remanding order for findings under Section 10(c)(2) of the Act).

The courts have held that that the effect of "vacating" a decision on appeal is that it "deprives that [decision] of precedential effect." County of Los Angeles v. Davis, 440 U.S. 625, 634 n.6 (1979). See also O'Connor v. Donaldson, 422 U.S. 563, 577-78 n.12 (1975); Zeneca Ltd. v. Novopharm Ltd., 919 F. Supp. 193, 198 (D. Md. 1996) ("[I]t is clear that the vacated Barr decision has no binding precedential effect here."). Accordingly, pending further action on remand, it is our view that the Commission's Order cannot be cited for the proposition that the merged AEP/CSW system is fully compliant with the "integration" requirements of Section 11(b)(1) of the Act. The Court of Appeal's decision does not, however, affect the status

of AEP and its subsidiary companies as members of a registered holding-company system, fully subject to the provisions of the 1935 Act and the Commission's rules thereunder.

The staff's concurrence in this view is critical because the company has several important and time-sensitive applications that are awaiting Commission action:

- In File No. 70-10021, AEP is seeking authority to issue and sell up to $3.0 billion of common stock, preferred securities, debt securities, stock purchase contracts and stock purchase units.

  The notice period on this filing expired on February 4, 2002, and there were no interventions. We have been working closely with the staff and believe that the record is complete. The requested authority will enable AEP to adjust its capital structure by issuing additional equity if necessary to address rating agency concerns, an ability that is of the utmost importance in today's volatile markets. We would request, therefore, that the Commission issue an order in this matter as quickly as possible, but in no event later than February 15, 2002.

- In File No. 70-9785, AEP is seeking authority to enable it to comply with Texas and Ohio-mandated restructuring. The FERC ALJ has recently certified a settlement to the full Commission. It is anticipated that the necessary FERC approvals could be received in early March. Accordingly, we would ask the Staff to issue the notice in File 70-9785 and to proceed as expeditiously as possible to complete its review in this matter.

  As a technical matter, this application will require the approval of utility acquisitions under Sections 9 and 10 as a result of the restructuring of certain of AEP's utility operations. We must emphasize that the proposed restructuring does not involve the acquisition of new utility operations or the growth or extension of utility systems. Rather, these are purely intrasystem transactions intended to comply with the requirements of state law. We would request that the Commission grant the requested authority and reserve jurisdiction, to the extent it deems appropriate, over those discrete findings that were the subject of the NRECA v. SEC remand. See Rule 24(c)(3)(ii) ("Every order granting an application or making effective a declaration shall, unless otherwise expressly ordered, be subject to the following condition: That the Commission reserves jurisdiction to pass upon any matter which the declaration or application proposes shall be subject to future consideration by the Commission.")).

Needless to say, AEP believes that the Commission, on remand, should reach the same correct conclusions that it did in issuing the original Order, the core of which has been upheld by the D.C. Circuit. But should the Commission, for any reason, determine on remand that the integration standards of the Act have not been met in some respect, it will have the full authority and jurisdiction to require that the company take such action as necessary to meet those requirements. See Section 11(b)(1) of the Act, 15 U.S.C. § 79k(a) (directing Commission to examine structure of public holding companies to determine "the properties and business [are]

thereof confined to those necessary or appropriate to the operations of an integrated public-utility system").

Conclusion

We would be happy to meet with you. Please call either Jim at (202) 639-7792 or Joanne at (202) 639-7785.

Proceedings on Remand from D.C. Circuit's Decision in NRECA v. SEC

This memorandum is submitted on behalf of American Electric Power Company, Inc. ("AEP"), to outline generally the approach proposed by AEP to resolve the two issues that remain before the Securities and Exchange Commission on remand from the January 18, 2002, decision of the United States Court of Appeals for the District of Columbia Circuit in *National Rural Electric Cooperative Association v. SEC*, 276 F.3d 609 (D.C. Cir. 2002) ("*NRECA v. SEC*").

In its decision, the Court found that the Commission had failed to explain adequately certain of its conclusions under the Public Utility Holding Company Act of 1935. Specifically, the Court determined that further findings are required with respect to the statutory requirements that an "integrated public-utility system" be: (i) "physically interconnected or capable of physical interconnection" and (ii) "confined in its operations to a single area or region." Section 2(a)(29)(A) of the Act. With the evidence AEP now proposes to add to the existing record, the Company believes there will clearly be sufficient evidence to support all aspects of the Commission's decision to approve the merger, including its findings on "interconnection" and "single area or region." So long as the Commission fulfills its duty to explain and justify its decision in a manner consistent with the Court's analysis, it should be entitled to the full scope of deference afforded by the *Chevron* line of cases.[1]

AEP submits that the Commission's initial decision should be reaffirmed, and that express findings should be made to supplement its prior analysis on these two points, and seeks the Staff's concurrence in its proposed approach.

Background

In the *NRECA v. SEC* decision, the Court was reviewing the Commission's order approving the acquisition by AEP of the securities of Central and South West Corporation ("CSW") and related transactions under the 1935 Act. *American Electric Power Co.*, Holding Co. Act Release No. 27186 (June 14, 2000) (the "Order").[2] The Order went into immediate

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[1] *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984); *Madison Gas & Elec. Co. v. SEC*, 168 F.2d 1337, 1339 (D.C. Cir. 1999).

[2] Specifically, the Order authorized: (i) the indirect acquisition of CSW; (ii) the acquisition of CSW Credit, Inc.; (iii) certain intrasystem financing transactions; (iv) the consolidation of the nonutility businesses of AEP and CSW; (v) the merger of the CSW subsidiary service company with American Electric Power Service Corporation ("AEP Service") with AEP Service as the surviving entity succeeding to certain authority of the CSW service company; (vi) CSW to distribute or pay as a dividend to AEP the common stock of one or more nonutility subsidiaries; (vii) AEP to use the proceeds of certain financings to invest an amount equal to 100% of the

effect on June 14, 2000 and, pursuant to the Order, the merger was completed on June 15, 2000. During the eighteen months that the matter was pending on appeal, AEP and its subsidiaries operated as members of a registered holding-company system under the 1935 Act, and are continuing to so operate pending the outcome of the remand proceedings.

In its decision, the D.C. Circuit upheld the Commission's determination under Section 10(c)(2) that the merger would "serve the public interest by tending towards the economical and efficient development of an integrated public-utility system" by, among other things, producing cost savings of approximately $2.1 billion. *NRECA v. SEC* at 619. The Court, however, agreed with petitioners that the Order did not adequately explain the Commission's conclusion under Section 10(c)(1) that the proposed merger would not be "detrimental to carrying out the provisions of Section 11." *Id.* at 610.

As explained more fully herein, the evidence of record, together with the additional evidence AEP intends to provide, will establish an ample basis for the Commission's findings under Section 10(c)(1) and, by reference, Section 11.[3] This is important because Section 11 has long been viewed as the "very heart" of the 1935 Act. The legislative history explains that "the purpose of section 11 is simply to provide a mechanism to create conditions under which effective State and Federal regulation will be possible." S. Rep. No. 621, 74th Cong., 1st Sess. 11 (1935). In this regard, Section 1(b)(4) of the 1935 Act identifies, among the problems the statute was intended to address, that:

> the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interests of consumers of electric energy and natural and manufactured gas, are or may be adversely affected *when the growth and extension of holding companies bears no relation to economy of management and operation or the integration or coordination of related operating properties.*

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combined system's consolidated retained earnings in exempt wholesale generators and foreign utility companies and (ix) certain actions with respect to stock-based benefits plans maintained by CSW and AEP.

[3] It is also worth noting that the D.C. Circuit has held that the Act requires something less than strict compliance with the standards of Section 11 in the Commission's determinations under Section 10. *See Madison Gas & Electric Co. v. SEC*, 168 F.3d 1337, 1342-43 (D.C. Cir. 1999) ("By its terms, however, section 10(c) (1) does not require that new acquisitions comply to the letter with section 11. In contrast to its strict incorporation of section 8 (proscribing approval of an acquisition "that is unlawful" thereunder), with respect to section 11 section 10(c)(1) prohibits approval of an acquisition only if it 'is detrimental to the carrying out of [its] provisions.'").

Emphasis added. To that end, Section 11(b)(1) requires that the Commission limit the operations of a registered holding company to "a single integrated public-utility system," which is defined as it relates to electric utility operations as:

> a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation.

Section 2(a)(29)(A) of the Act.

With respect to the requirements of Section 2(a)(29)(A), the petitioners did not challenge the Commission's findings that the AEP electric utility operations would, post-merger, "be economically operated as a single interconnected and coordinated systems," and that the combined system would not be "so large as to impair . . . the advantages of localized management, efficient operation, and the effectiveness of regulation."[4] The petitioners, however, argued and the Court agreed that the Commission's decision was lacking in two respects. The Court found that:

(1) The Commission failed to provide a "satisfactory explanation" in the Order for its determination that the proposed merger met the statutory requirement that the system be "physically interconnected or capable of physical interconnection," *NRECA v. SEC* at 616; and

(2) The Commission "failed to make any evidentiary findings" or to engage in the proper legal analysis to support its conclusion that the resulting system would be "confined in its operations to a single area or region," *id.* at 617.

Based on these conclusions, the Court vacated the Order and remanded for further proceedings "consistent with this opinion." *Id.* at 619.

Proposed Approach

1. Scope of the Remand.

[4] Nor did the petitioners challenge the Commission's findings under Section 10(b)(3) that the proposed merger would not be detrimental to "the public interest or the interest of investors or consumers or the proper functioning of such holding-company system."

While the Court did direct the Commission to address the "interconnection" issue, the scope of the remand is narrowly defined. Importantly, the Court affirmed the Commission's basic conclusion that contract rights may suffice to meet the "physical interconnection" requirement. It also agreed with the Commission that a 250 MW path provides a sufficient power flow to satisfy the statute (*id.* at 614-15). The issue on remand is, first, whether a "unidirectional flow of power from one-half to the other" of the system can meet the "integration" requirements (*id.* at 615). Second, the Court also directed the Commission either to explain why the AEP decision is consistent with the Commission's "own prior reasoning regarding interconnection of distant utilities" or to provide a "reasoned analysis indicating that prior policies and standards are being deliberately changed," and why that change is legitimate (*id.* at 616).

The other "remanded" issue is that of "single area or region." Here the Court acknowledged that there may be a "legitimate basis" for finding AEP's service territories and CSW's service territories to be in the same "area or region" (id. at 618-19). It found, however, that the Commission's original Order "failed to justify its finding that the proposed acquisition will satisfy the single-area-or-region requirement" (*id.* at 610).

AEP believes that the Commission's notice seeking public comment on remand should be narrowly tailored to limit the solicitation of comments to these two issues, and should track the Court's own description of the scope of these issues.

2. Interconnection

The Commission needs to satisfy the Court that the merger meets the statutory criterion that utility assets be "physically interconnected or capable of physical interconnection." While the petitioners originally raised numerous objections with respect to this criterion based on the proposed use of a contract path as the primary means of interconnecting the former AEP and CSW systems, most of these objections were rejected by the Court.

In particular, the Court rejected the petitioners' argument that the contract path was too "small" and would allow for transmission of only a "token amount" of power. The Court emphasized that there is "no statutory language, legislative history, or case law requiring that physically separated zones of a power system be interconnected by lines capable of transmitting any specified percentage of the power generated in each zone." *NRECA v. SEC*, 276 F.2d at 614. It also rejected the petitioners' argument that the contract was of limited duration, and therefore too "tentative." The Court relied on the Commission's statement that it could "order New AEP to divest one of the systems if the company fails to devise a satisfactory method of integrating its utilities after the contract with Ameren expires." *Id.* at 614-15. The Court also rejected the petitioners' argument that allowing the interconnection requirement to be satisfied based on a contract path alone (without plans to build a future tie-in) was inconsistent with its precedent in the *Madison Gas* case. *Id.* at 615.

The Court's concerns with respect to interconnection, rather, were directed to the Commission's acceptance of a "unidirectional contract path," and to the Court's view that the Commission had failed adequately to distinguish prior precedents which suggested that a

contract path might not suffice to integrate "distant" systems. *Id.* at 615-16. Each of these is addressed below.

a. Unidirectional Flow of Power.

The Court focused on the statutory term "interconnection," which it found to connote "*mutual* connection," a definition "that seems, on its face, to require two-way transfers of power." *Id.* at 615. The Court added that it failed to see how a system restricted to a "unidirectional flow of power from one half to the other" could be operated as a "single interconnected and coordinated" whole. *Id.*

On remand, the Commission should make express findings to clarify and emphasize that the combined AEP system is not simply connected by a "unidirectional flow of power" but rather has the capability for "two-way transfers of power," which it can use to the full extent such transfers may be necessary and economic. Although it is true that the firm contract path is unidirectional (consistent with the likely power needs of the system), use of an agreement for firm transmission is not the only means of transmitting power (or of interconnecting utility assets). In its initial order, for example, the Commission noted that:

> In addition to the use of the Contract Path, quantities in excess of 250 MW may be moved within the New AEP System in any given hour by using non-firm transmission rights. These additional transfers will be made when they would be economical for New AEP System operations, after taking opportunity costs into consideration.
>
> Applicants also expect that, from time to time, there will be opportunity to transfer energy economically from the West Zone to the East Zone. In these circumstances, Applicants will make use of their rights to nominate secondary points of receipt and delivery under their transmission service agreements with Western Resources and Ameren.

While these findings were made in the context of addressing the separate statutory requirement that the proposed system be capable of "economic and coordinated operation," Order at 37, the Court's opinion itself recognizes that these two requirements are related, *id.* at 615, and that the Commission's findings that there are non-firm avenues for transmitting power in both directions, in addition to the one-way contract path for firm transmission, are directly relevant to the "interconnection" requirement.

Further, the Commission should expand upon its findings concerning the use of open access transmission service as a means of interconnecting utility assets. The Commission noted in its original decision, but did not rely upon, the "efforts of the FERC to restructure the way in which transmission is provided and obtained in the U.S.," including FERC's Order 888

mandating open access to FERC-jurisdictional transmission facilities. Order at n. 59. Since that time, FERC's open access transmission service regime has been more fully realized. Through these open access transmission requirements, AEP has improved ability to transmit power west-to-east, as well as east-to-west.

Under FERC's Order 888, FERC-jurisdictional utilities have the legal right to purchase available transmission capacity from other FERC-jurisdictional utilities on non-discriminatory terms. Utilities have implemented Order 888 and the FERC's follow-up Order 889 by adopting open access transmission tariffs ("OATTs") and posting available transmission capacity on a publicly-available open access same-time information system ("OASIS"). OATTs afford utilities, such as AEP, the same right to purchase available transmission capacity on non-discriminatory terms as the facilities' owner enjoys, and OASIS makes available transmission capacity transparent and easy to access.

The Commission has already recognized the importance of Order No. 888 in the interconnection context:

> [Order No. 888 means that] transmission users no longer need to build their own transmission lines or lease them from third parties in order to secure reliable transmission capacity. Indeed, the primary purpose and effect of Order No. 888 is to give transmission users rights of access to third party facilities that are on a par with the rights of the transmission owners. Consequently, transmission users do not need to buy more transmission than they need to support specific transactions.[5]

In light of this fundamental change in the regulatory requirements applicable to electric power transmission, it is important for the Commission to continue to adapt its approach to interpreting the statutory "interconnection" requirement. As the Commission has recognized, were it to require firm, two-way transmission contracts in every proposed merger under the Act between two non-contiguous systems, it would force utilities to purchase firm transmission that is unnecessary and uneconomic. Such a requirement would needlessly limit the flexibility and consume the resources of such utilities and "could constrain parts of the grid, to the detriment of other potential transmission users."[6]

Consistent with this reasoning, since the advent of FERC's open access regime under Order 888, the Commission has expressly held that non-contiguous utilities can show interconnection through adequate available transmission capacity under intervening utilities' OATTs.[7] This development is the natural extension of the Commission's prior "interconnection"

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[5] *CP&L Energy Inc.*, Holding Co. Act Release No. 27284, at n.25 (Nov. 27, 2000).

[6] *Id.* Such a requirement would also be inconsistent with FERC transmission policy.

[7] *See CP&L Energy, Inc.*, Holding Co. Act Release No. 27284 (Nov. 27, 2000) (concluding that a firm contract path is unnecessary to show interconnection between two non-contiguous

decisions, in which the Commission has adapted its interpretation of the statutory language as has been necessary and appropriate in light of technological and regulatory developments in the field.[8] In the CP&L Energy case, the Commission approvingly recited the applicants' explanation as to why open access transmission "offers a better, more flexible and more economical way to achieve significant interchange capability than the more traditional firm contract path":

> Open access transmission makes it possible now for the [non-contiguous areas of the Carolina Power & Light Company system] to coordinate their operations through the use of OATTs and

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parts of a utility system where adequate transmission is available through open access, using the OATTs of other utilities and OASIS, and through other transmission arrangements); *Exelon Corp.*, Holding Co. Act Release No. 27256 (Oct. 19, 2000) (determining that a combination of a 100 MW firm contract path in one direction and adequate available transmission capacity in the other direction sufficed to interconnect PECO and Commonwealth Edison).

[8] In its very early cases, the SEC indicated that it would require non-contiguous operating companies to interconnect through their own transmission lines, *see, e.g., The North American Co.*, Holding Co. Act Release No. 3405 (1942), but the SEC soon amended this narrow view, holding that the right to use a third party's transmission lines also satisfied the interconnection requirement. *See Cities Serv. Power & Light Co.*, 14 S.E.C. 28, 53 n.44 (1943); *Electric Energy, Inc.*, 38 S.E.C. 658, 668-671 (1958); *New England Elec. Sys.*, 38 S.E.C. 193, 198-99 (1958); *Centerior Energy Corp.*, Holding Co. Act Release No. 24073 (Apr. 29, 1986); *Northeast Utils.*, Holding Co. Act Release No. 25221 n.75 (Dec. 21, 1990); *Conectiv Inc.*, Holding Co. Act Release No. 26832 (Feb. 25, 1998); *WPL Holdings, Inc.*, Holding Co. Act Release No. 26856 (Apr. 14, 1998). This change in interpretation has been approved by the Court. *See Madison Gas & Elec. Co. v. SEC*, 168 F.2d 1337, 1340 (D.C. Cir. 1999).

During the 1950's and 1960's, the Commission further developed its interpretations, holding that a generating plant and its sponsoring companies could be interconnected through a "transmission grid," *Connecticut Yankee Atomic Power Co.*, Holding Co. Act Release No. 14968 (Nov. 15, 1963), or a "transmission network," *Yankee Atomic Elec. Co.*, 36 S.E.C. 552 (Nov. 25, 1955). The Commission also decided that non-contiguous companies could show interconnection without the ability to transfer unlimited amounts of power over a third party's line, at least where they can supplement power transfers through potential transmission contracts with other parties. *Mississippi Valley Generating Co.*, 36 S.E.C. 159 (1955). By the 1970's, when utilities were voluntarily forming regional associations to improve reliability and economy of power supply, the Commission reacted to this change in the industry by relying on transmission agreements among members of the regional associations to find interconnection. *See, e.g., Conectiv, Inc.*, Holding Co. Act Release No. 26832 (Feb. 25, 1998); *Unitil Corp.*, Holding Co. Act Release No. 25524 n.29 (Apr. 24, 1992); *Centerior Energy Corp.*, Holding Co. Act Release No. 24073 (Apr. 29, 1986). The Commission's recent decisions recognizing open access transmission rights as a means of "interconnecting" non-contiguous utility systems are the natural extension of these decisions in the current regulatory context.

> OASIS. . . . [Applicants] explain that reliance on numerous transmission service reservations increases the number of potential interconnection options and allows utilities to use less expensive non-firm products where appropriate, while providing a high level of assurance that transmission capacity will be available when needed. Utilities can obtain a portfolio of transmission capacity over multiple paths, with various degrees of firmness, providing for various amounts of capacity that can be selected to achieve optimal integrated operations. Today, interchange capacity can be achieved via a portfolio of short-term firm and non-firm transmission at a lower comprehensive cost than the more limited, rigid, single firm contract path.[9]

This construction of the statute, which takes into account the current regulatory and technological conditions in the industry, is entitled to deference from the courts. *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984); *Madison Gas & Elec. Co. v. SEC*, 168 F.2d 1337, 1339 (D.C. Cir. 1999).

The evidence supports the foregoing analysis. During the calendar year 2001, almost 21,000 MWH of energy were transferred from West to East in the AEP system, and during the first seven months of 2002, nearly 32,000 MWH of energy were sent from West to East. AEP will supplement the record with additional evidence regarding the availability of capacity for the transmission of power and energy from West to East in the AEP system at those times when it is economical for AEP to do so.

Based on all of this evidence – including the contract path for firm transmission, the availability of non-firm transmission options, available transmission capacity and rights to use the open access transmission system – the Commission should expressly find that the two parts of the combined AEP system are "physically interconnected or capable of physical interconnection" within the meaning of the Act, including the capability for "two-way transfers of power." *NRECA v. SEC* at 615.[10]

b. Consistency with Prior Precedents.

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[9] *CP&L Energy Inc.*, Holding Co. Act Release No. 27284 (Nov. 27, 2000).

[10] The Commission should also note that, to the extent that the Court raised, *sua sponte*, the question whether the proposed method of interconnection would allow the system to be "economically operated as a single interconnected and coordinated" whole, *AEP*, 276 F.3d at 615, the Commission's conclusion that this criterion was satisfied was not challenged in the petition for review and was not before the Court on appeal. In any event, for the same reasons that the "interconnection" requirement is satisfied, the interconnection is also sufficient, as the Commission found, to allow the "economic and coordinated operation" of the system, a determination that also takes into account many additional factors.

The Commission also needs to explain why its decision in this case is consistent with, or reflects a considered departure from, the Commission's past precedents. In finding an "apparent conflict," the Court cited prior decisions in which the Commission had suggested that "contract rights cannot be relied upon to integrate two *distant* utilities," and perceived a failure on the Commission's part to provide a "reasoned analysis indicating that prior policies and standards are being deliberately changed." *NRECA v. SEC* at 615-16.

The Court appeared to accept the Commission's premise that the length of a contract path was relevant not to the question of interconnection but rather to the determination whether interconnected utilities met the "single area or region requirement." The Court noted, however, that the Commission had "failed explicitly to consider the length of the contact path in deciding whether New AEP meets the region requirement." *Id.* at 616.

With respect to this issue, the Commission should expressly state that, to the extent *dicta* in its earlier decisions suggested otherwise, it is clarifying that the distance between utility assets is not a legal limitation with respect to satisfying the "interconnection" requirement of the statute. AEP believes that the Commission correctly concluded that distance is a factor to be taken into account in the context of "single area or region" and, as discussed more fully herein, urges the Commission to make express findings on this point. If this approach could be viewed as a change in policy, it is a change supported by a "reasoned analysis," as set forth below.

First, this reading of the Act is sound as a matter of statutory construction. Just as the Court found that the plain language of the Act does not contain any requirement that utility assets be "interconnected by lines capable of transmitting any specific percentage of the power generated in each zone," *id.* at 614, the same is true with respect to the length of the interconnection. The statutory language does not suggest that any particular proximity between utility assets is required for two systems to be "physically interconnected or capable of physical interconnection."

Second, a flexible reading of the "interconnection" requirement in this regard is also important because of the changing nature of the technology in this area. Whether two non-contiguous systems are capable of physical interconnection is not a function of any absolute distance limitations but rather is dependent on the constraints of current technology in the electric industry. As the Commission observed in approving the merger, for example, "a geographic radius of 1,000 miles or more is currently considered reasonable for choosing among supply options." Order at 60.

By contrast, at the time the Act was passed in 1935, witnesses emphasized that most power was consumed within 15 to 25 miles from the point of generation,[11] and that the

[11] *See* Testimony of ICC Commissioner Walter M. W. Splawn, Hearings Before the Senate Committee on Interstate Commerce at 75-76 (April 16, 1935).

maximum range for transmission of power was around 300 miles, which was uncommon.[12] These technological limitations will undoubtedly change again in the future, as technology further advances. Were the Commission to attempt to set specific distance limitations concerning the system components that can be "physically interconnected," its reading would quickly be outdated by new technological developments. The statutory meaning of a "physical interconnection" should be not be subject to artificial or arbitrary distance rules.

Third, while the Court found that the Commission had expressed a "clear policy," it must also be emphasized that the Commission never applied its *dicta* concerning "distant" systems to find that two systems failed to meet the interconnection criterion. Rather, each of the prior cases in which this *dicta* has been stated were cases in which the Commission was emphasizing that the merger was permissible. In the early 1990's, the Commission stated in *dicta* in several cases that contract rights could not be "relied upon" to "integrate" distant utilities. *See Unitil Corp.*, Holding Co. Act Release No. 25524, n.30 (Apr. 24, 1992); *Northeast Utilities*, Holding Co. Act Release No. 25221, at n.75 (1990).[13]

In each of the cases in which these statements appear, however, the Commission found that the utilities at issue were interconnected through a contractual path and were integrated. Thus, the Commission never applied these statements to any set of facts in which it determined that the use of contract rights did not result in integration. Similarly, in the early cases in which the Commission recognized that a right to use third-party transmission lines may be relied upon to interconnect non-contiguous utility systems, it did not read any "distance" limitation into the statute. *See, e.g., Cities Service Power & Light Co.*, 14 S.E.C. 28, 53 n.44 (1943); *Electric Energy, Inc.*, 38 S.E.C. 658, 668-671 (1958); *New England Electric System*, 38 S.E.C. 193, 198-99 (1958).

Thus, the Commission's clarification is not only a reasonable reading of the statute, but it is also neither a departure from a longstanding policy nor an abandonment of any rule that has actually been applied in practice.[14]

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[12] *See id.*; *see also id.* at 85 (a company's service area "has to be small, because they cannot send power very far").

[13] In *WPL Holdings, Inc.*, Holding Co. Act Release No. 26856 (Apr. 14, 1998), the Commission stated similarly that "combined electric properties can be interconnected, where the utilities are not separated by significant distances, by means of contractual rights to use the lines of a third party." In *WPL*, the Commission found that that the "distances at issue" in the *WPL Holdings* case were "within the parameters of the previous decisions," and did not revisit the issue. *Id.* at n.39.

[14] To the extent that the Commission's *dicta* suggested that distance could be relevant, if not to the "interconnection" requirement, than more broadly to the general integration requirement, the Commission can expressly clarify that the distance between system components is not a *per se* limitation on whether the merger of those assets can form an "integrated" public utility system,

3. *Single Area or Region.*

a. *The "Single Area or Region" Requirement as a Separate Element in the Definition of "Integrated Public-Utility System".*

The Court acknowledged that the Commission "may make its own decision regarding the meaning of the region requirement" and that while "the Commission could potentially point to boundaries identified by NERC or FERC" it is not bound by the regions or areas defined by other entities.[15] *NRECA v. SEC* at 617. Further, the Court "accepted as true" the Commission's statements that "the terms 'area' and 'region' are 'by their nature . . . susceptible of flexible interpretation," and that "'recent institutional, legal and technological changes have reduced the relative importance of geographic limitations' on utility systems." *Id.* at 617-18. However, the Court held that the Commission had not fully explained the relationship of these statements to the facts at hand.

Specifically, the Court criticized the Commission's "single area or region" determination as having relied on a finding that "New AEP satisfies all other PUHCA requirements," *id.* at 618, rather than having analyzed the "single area or region" requirement as a separate element necessary to satisfy the definition of an "integrated [electric] public-utility system" in Section 2(a)(29)(A). According to the Court, the Commission read Section 2(a)(29)(A) as if it provided that an integrated system should be confined to "an area or areas not so large as to impair . . . ," rather than "confined to a single area or region." *Id.*

The Court also found that the Commission "failed to make any evidentiary findings on the issue," *id.* at 617, and cited two prior Commission decisions in which it described the Commission as having "analyzed such factors as the geographic and socioeconomic characteristics of the areas covered by the system."[16] In contrast, the Court asserted, the Commission's decision had not relied on "any identified similarities between the areas currently served by AEP and those served by CSW," *id.* at 618, and "[n]ever mention[ed] whether the territories served by AEP and CSW have common geographic and geologic traits," *id.* at 617.

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either with respect to the "interconnection" requirements, for the reasons stated above, or to the consideration of "single area or region," as addressed below.

[15] 276 F.3d at 617. This approach only makes sense. Were the Commission required to divide the country into set geographic regions – for example, by adopting the petitioners' suggestion that the Commission limit itself to the specific geographical boundaries developed by regional power pools – even contiguous systems that were closely interconnected could be deemed not to operate in a "single area or region" if they happened to fall on two sides of an arbitrary geographic line. Such a reading would make no sense, and the Court agreed that the Commission rightly rejected any such approach as controlling its determinations.

[16] *Middle West Corp.*, 15 S.E.C. 309, 336 (1944); *American Natural Gas Co.*, 43 S.E.C. 203, 206 (1966).

To the extent that the Court's remand order requires the Commission to state explicitly why the combined system is confined in its operations to a "single area or region," the evidence of record, together with the additional evidence to be submitted by AEP, provides an ample basis for the Commission to make clear that it has given independent consideration to the "single area or region" requirement and has not merely found the requirement to be satisfied because the other three requirements of an "integrated public-utility system" have been met. However, there are several considerations that should be emphasized in this connection.

First, it is the Commission, not the Court, that is charged with interpreting the 1935 Act. As the Supreme Court has explained, a reviewing court must defer to an agency's interpretation of its own statute with respect to matters as to which Congress has not spoken if that interpretation "is based on a permissible construction of the statute."[17] In this case, Congress explicitly provided for the Commission to determine how best to effectuate the purposes and requirements of the statute.[18] See, e.g., Section 1(c) (directing the Commission to interpret all provisions of the Act "to meet the problems and eliminate the evils as enumerated in this section"); and Section 20(a) (authorizing the Commission to "make, issue, amend, and rescind such rules and regulations and such orders as it may deem necessary and appropriate to carry out the provisions of this title"). In its first year of administration of the 1935 Act, the Commission stated that "[t]he general policy of the Commission in administering this legislation is to give full effect to the Congressional intent of preventing the repetition of abuses which led to the passage of the Act and to make the administration of the law as workable as possible without imposing restrictions of a kind which bear no relationship to the purposes to be achieved."[19] The Act requires the Commission to review proposed mergers, acquisitions, or other securities transactions of registered holding companies and to disapprove transactions that

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[17] *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984). *See also United States v. Mead Corp.*, 533 U.S. 218, 226-27 (2001) (holding that "administrative implementation of a particular statutory provision qualifies for *Chevron* deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority").

[18] *See Centerior Energy Corp.*, Holding Co. Act Release No. 24073 (Apr. 29, 1986); *American Electric Power Co., Inc.*, 46 S.E.C. 1299, 1309 (1978) (Sections 10(c)(2) and 10(b)(1) "are couched in discretionary terms and require the Commission to exercise its best judgment as to the maximum size of a holding company in a particular area, considering the state of the art and the area or region affected"); *see also Yankee Atomic Elec. Co.*, 36 S.E.C. 552, 564-65 (1955) ("We think it clear from the language of Section 2(a)(29)(A), which defines an integrated public utility system, that Congress did not intend to impose rigid concepts with respect thereto.") (footnote omitted).

[19] First Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1935.

do not satisfy the statutory standards. The Commission's interpretation of the Act for the purpose of carrying out those duties commands a high degree of deference.[20]

Second, Congress explicitly directed the Commission to take account of changes in technology and economics in applying the standards of the Act. Section 2(a)(29(A) directs the Commission to "consider[] the state of the art" in determining whether a public utility system is properly integrated. Further, the Commission and the courts have recognized the need to consider a proposed transaction "in the light of contemporary circumstances . . . and of our present view of the Act's requirements," as well as to the need to "refashion[] . . . from time to time" the Act's "system of pervasive and continuing economic regulation . . . to keep pace with changing economic and regulatory climates."[21] Accordingly, the Commission should not hesitate to recognize the impact of changes in engineering and technology – or the policies of other regulators, such as the FERC – on its determination of whether a system satisfies the "single area or region" requirement.[22]

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[20] *See, e.g., Environmental Action, Inc. v. SEC*, 895 F.2d 1255, 1259 (9th Cir. 1990) (noting high degree of deference applied to SEC's interpretation of PUHCA); *SEC v. Associated Gas & Elec. Co.*, 99 F.2d 795, 798 (2d Cir. 1938) (stating that the Act's administration is "the peculiar function of the [SEC]" whose interpretation "should control unless plainly erroneous").

[21] *Union Electric Co.*, 45 S.E.C. 489, 503 & n. 52 (1974), *aff'd without opinion sub nom. City of Cape Girardeau v. SEC*, 521 F.2d 324 (D.C. Cir. 1975). *See Connecticut Yankee Atomic Power Co.*, 41 S.E.C. 705, 710 (1963) (finding the "single area or region" requirement met "in view of the existing state of the arts of generating and transmission and the demonstrated economic advantages of the proposed arrangement[]."); *American Electric Power Co., Inc.*, 46 S.E.C. 1299, 1309-10 (1978) (noting that technological developments between 1946 and 1978, including the increased size of generating units and improved transmission of electricity over greater distances, justified larger systems than had been permitted in earlier years); *see also Mississippi Valley Generating Co.*, 36 S.E.C. 159, 186 (1955) ("Congress did not intend to impose rigid concepts but instead expressly included flexible considerations," including the statutory references to "the state of the art and the nature of the area or region affected" – factors that are "in their very nature conceived of as involving changing conditions and requiring individual examination.").

[22] Clearly, there is a potential for tension between the FERC's market power concerns and an interpretation of Section 2(a)(29)(A) that would require geographic proximity or continuity between operating problems. In other contexts, the SEC and the courts have deemed it appropriate for the Commission to look to the FERC for its expertise in resolving anticompetitive operational issues. *Northeast Utilities*, Holding Co. Act Release No. 25273 (Mar. 15, 1991), *aff'd sub nom City of Holyoke Gas & Electric Department v. SEC*, 972 F.2d 358 (D.C. Cir. 1992).

Third, Section 2(a)(29)(A) must be interpreted as a whole and in light of the overall purposes of the Act.[23] While the Commission (absent a major change in its interpretation of the 1935 Act) must give independent weight to the "single area or region" requirement, it remains true that evidence that supports one requirement may also be relevant to and support other requirements.[24] Without discounting the Court's conclusion that independent findings are required in connection with "a single area or region," AEP believes that the Commission was correct that its findings under other provisions of the Act are relevant to the question of "single area or region" and that this point should be developed in the proceeding on remand.

Fourth, the Commission has rarely had occasion in recent years to discuss the "single area or region" requirement as a separate factor in great detail. As a result, while the Court and other commentators frequently reference the discussion of the "single area or region" requirement in the 1944 and 1945 *Middle West* orders, it is unclear whether they have fully understood those orders. In this case, the Court seems to have lost sight of the fact that the Commission must address the issue of whether a public-utility system is integrated, not whether it is located in an area that happens to enjoy "common geographic or geologic traits," as the Court's opinion implies. *See* 276 F.3d at 617. As discussed below, the 1944 and 1945 *Middle West* orders show that the Commission examines the "single area or region" requirement in the context of utility integration, not just geologic or economic factors.

In the 1944 *Middle West* order, the Commission considered whether to permit the utilities in each of two parts of what later became the CSW system to remain together under Section 11.[25] One group of companies consisted of Public Service Company of Oklahoma

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[23] *See Dole v. United Steelworkers*, 494 U.S. 26, 35 (1990) ("[I]n expounding a statute, we are not guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.").

[24] *See WPL Holdings, Inc.*, Holding Co. Act Release No. 25377 (Sept. 18, 1991) (explaining that "some overlap of the analyses under section 10(c)(1) and 10(c)(2) is inevitable"; rather than "double counting," such overlap is "an incident of the application of a broad and comprehensive statute to the specifics of this particular situation"); *Entergy Corp.*, 51 S.E.C. 869, 876 n.35, citing *WPL Holdings* ("the Act repeats certain requirements in various statutory provisions to ensure complete supervision over the development of holding company systems"); *Commonwealth & Southern Corp.*, Holding Co. Act Release No. 7615 (Aug. 1, 1947) ("We do not, in applying particular size standards, lose sight of the objectives of other criteria. There must be a reconciliation of all objectives to the end of accomplishing a satisfactory administration of the Act.").

[25] Although the Commission's decisions under Section 11 include some of the most extensive discussions of the "single area or region" requirement, they also include dicta that the Commission might permit an existing system to continue under facts that would not lead it to approve a new system. While the effect of those dicta is unclear, they appear to relate more appropriately to the "not so large as to impair" factor than to the "single area or region" factor, as a system is either in a "single area or region" or it is not.

("PSO"), Southwestern Light & Power Co. ("Southwestern Light"), and Southwestern Gas & Electric Co. ("Southwestern Gas"). Although PSO and Southwestern Light were separated by territory controlled by Oklahoma Gas & Electric Company, the Commission found that Southwestern Light's future capacity needs were more likely to be satisfied by PSO than by Southwestern Gas. Not only did the three companies conduct coordinated operation that was "economical to a substantial degree,"[26] but the supply of power to Southwestern Gas "by means of interconnection rather than local installations" was seen as less risky, because much of that company's load was "devoted to the oil industry" which was a business "particularly subject to fluctuation."[27] In discussing the "single area or region" requirement, the Commission acknowledged the large size of the territory, but suggested that it was not "well-settled" or "economically developed." It was, however, "more or less typical throughout, relying largely on oil and other minerals, agriculture, and relatively light industry for its subsistence." The key, however, appeared to be the need to provide "satisfactory service":

> The rendition of satisfactory service in arid and sparsely-settled areas frequently requires the stretching of lines over long distances to connect small population centers with generating facilities strategically placed near suitable water and fuel supplies. In view of these facts, we believe that the properties in question lie within a single area or region.[28]

The second set of companies considered in the 1944 *Middle West* order consisted of West Texas Utilities Company ("WTU") and Central Power & Light Company ("CP&L"). The Commission again recognized that those companies were "interconnected" and "capable of economical coordinated operation."[29] Although the "enormous territory" involved gave the Commission pause, it viewed the "sparse settlement" of the area, "the difficulties of finding suitable generation locations because of water and fuel characteristics, the small size of communities widely separated and the necessity of stretching lines over long distances to accumulate load" as justifying a finding that the territories constituted a single area or region.[30]

In the 1945 order, the Commission decided that the two groups could remain in a single system, discarding the tentative conclusion it had stated in the 1944 order.[31] In doing so, it emphasized the factors that would make for success in operating an integrated system:

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[26] 15 S.E.C. at 334-35.

[27] *Id.* at 335.

[28] *Id.* at 336.

[29] *Id.* at 337.

[30] *Id.*

[31] *See Middle West Corporation*, 18 S.E.C. 296 (1945).

> In our prior opinion we discussed the size and geophysical conditions of the territory. The territory is a large one. However, as we have noted, it is unique in various respects. Limited supplies of adequate water, small and scattered population localities, the generally dispersed industrial and agricultural locations require high concentrations of generating capacity and long transmission lines. Neither localized management nor efficient operation nor the effectiveness of regulation . . . is impaired . . . particularly in light of demonstrated disadvantages of lack of coordination in this case.[32]

It was not "homogeneity" as such, but the loss of coordination benefits if the companies were not kept together, that seemed to influence the Commission's decisions most heavily, both in 1944 and 1945.[33]

The Commission's discussions also suggest that diversity of load can be more important to integration than "common characteristics." In the 1944 *Middle West* order, the riskiness of the oil industry load could be mitigated because Southwestern Gas could draw on capacity from PSO rather than building "local installations" to serve that load. The Commission went on to cite savings from "load diversity" as supporting the contention that the PSO-Southwestern Gas-Southwestern Light group of companies could be "economically operated" as a single system.[34] It also cited decisions in which it had found separated properties to be in the same area or region. For example, the Commission noted that in the *North American* case, it had "found properties surrounding the cities of St. Louis and East St. Louis integrated with properties lying far to the north around Keokuk and to the west in central Missouri."[35] It had also found "properties in southeast Wisconsin integrated with properties in the Michigan peninsula far to the north."[36] In the *Middle West* case, it suggested that limitations on the placement of generating

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[32] *Id.* at 299.

[33] *American Natural Gas Co.*, 43 S.E.C. 203 (1966), the other case specifically cited by the Court, does not present the type of analysis suggested by the Court's dicta. There, the Commission stopped short of finding all five states bordering on the Great Lakes as a single distinct region but noted that the principal cities served by the acquired company were closer to the headquarters of the one of the acquirer's two current subsidiary operating companies than was the principal city served by the other operating subsidiary. Based on that fact, it found that the post-acquisition company would be confined to a single area or region. 43 S.E.C. at 206. The case did not turn on a discussion of "common geographic and geologic traits," or "identified similarities between the areas currently served" by the merging companies.

[34] 15 S.E.C. at 335.

[35] 15 S.E.C. at 344 n.78. *See North American Co.*, 11 S.E.C. 194, 202-205 (1942).

facilities meant that "the economic joining of separated properties may form a natural integrated group," just as when "outlying sources of cheap hydro power form natural systems with large urban distribution centers." [37]

It is AEP's view that the initial Order in this matter was consistent with, and a logical application of, the precedent concerning "single area or region." The early cases, with their varying treatment of geographic factors, reflect the central purposes of the Act and, in particular, the emphasis on "economy of management and operation or the integration and coordination of related operating properties" (Section 1(b)(4) of the Act). In more recent decisions, the Commission has recognized that the standard for assessing economic benefits "is elastic and ... must be applied against the background of the circumstances of each particular case. Thus, in reviewing an application . . . , the Commission may recognize not only benefits resulting from the combination of utility assets, but also financial and organizational economies and efficiencies."[38] Against this background, the Commission properly tried to define an appropriate region, not by reference to geography *per se*, but instead by reference to the market and economic forces that led AEP and CSW to merge, including the likelihood that the merged entity could more effectively served its customers than the two existing systems standing alone.[39]

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[36] 15 S.E.C. at 344 n.78. *See Wisconsin Electric Power Co.*, 9 S.E.C. 941 (1941).

[37] 15 S.E.C. at 334 n.78.

[38] *WPL Holdings, Inc.*, Holding Co. Act Release No. 25377 (Sept. 18, 1991), *citing Central U.S. Utils.*, 8 S.E.C. 691, 701 (1941) and *American Elec. Power Co., Inc.*, 46 S.E.C. 1299, 1305 (1978).

[39] The Commission in its initial Order noted, among other things, that:

> Applicants state that generation mix and system reliability are two of the principal additional benefits contemplated from the Merger. Applicants explain that the New AEP System will have a more balanced generation mix that is less susceptible to fuel price volatility and supply interruptions than either the AEP System or the CSW System.
>
> In addition, Applicants state that the New AEP System will be better situated to provide more reliable electric service that it is possible for either the AEP System or the CSW System by itself. for example, the New AEP System will have a larger generating base after the Merger, and thus more generating resources to draw upon when units are down for maintenance or there is an unscheduled outage. As another example, Applicants state that the New AEP System should have a lower risk of unserved load than either the AEP System or the CSW System has, since each System has access to fewer interconnections to neighboring systems for

AEP is not suggesting that economies alone always define an appropriate region. The directive of Section 1 to eliminate "the growth and extension of holding companies [that] bears no relation to economy of management and operation or the integration or coordination of related operating properties" means that systems must make sense from the perspective of the goals of the Act. What is important, however, is not the Commission's reading of the geography or geology of a particular service area but rather its assessment of the integrative effect of combining two systems in a geographic area that makes sense viewed operationally. The Commission has always looked at considerations – be they geographic, demographic, economic or fuel-related – that relate to the logic of the combined company as a supplier of electricity. Thus, the Commission's reference to "geographic" and "demographic" factors in some cases should not be read to create a test for the "single area or region" requirement that is unrelated to other considerations in Section 2(a)(29)(A). The Commission's findings in those matters, as in all utility mergers, pertain to an analysis of regionality that is also focused on electricity.

In light of these considerations, AEP believes that the Commission's initial Order correctly found that the combined system would be confined in its operations to a single area or region but did not fully articulate the reasons that support the finding. As explained in the sections that follow, AEP will present significant additional evidence to support the Commission's prior finding that the merged system is located in a "single area or region," as required by Section 2(a)(29)(A). AEP believes that this information will assist the Commission in its task of supplementing its prior analysis on this point. In some regards, the information will also support the analysis suggested by the Court's dicta, focusing on common geographical and economic characteristics of AEP's region, as well as factors that tend to unify the region.

b. Common Characteristics of AEP's Area of Operations.

The Commission has traditionally approached the "single area or region" requirement through case-by-case determinations in which it looks to the particular characteristics of the areas in which the merging electric systems will operate, and considers whether the combined system will be integrated in light of economic, geographic, demographic, or other relevant characteristics, such that it should be deemed to operate in a "single area or region" for purposes of the Act. The Commission has not insisted that any particular characteristics be present to support such a finding but rather has looked to all of the evidence present in each case, and has tailored its findings to the facts and circumstances of the particular applicants.

Applying this standard to the case at hand, there are a number of factors common to the prior AEP and CSW systems that support the Commission's conclusion that the AEP system is confined in its operations to a "single area or region," discussed below.

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emergency support than the New AEP System will have. (Order at 66).

i. Traditional Common Characteristics.

Beginning with the traditional factors that the Commission has considered in past cases, the record as developed and supplemented will show that area in which the combined AEP system operates reflects the types of common characteristics that the Commission has traditionally considered in finding the "single area or region" criterion to be satisfied.

This commonality is demonstrated both by company-specific information and characteristics of the AEP service territory generally.

Among other things, AEP East has 24.86 customers per mile of transmission or distribution line while AEP West has 21.98 customers per mile of transmission or distribution line. These close ratios suggest very similar population densities in the respective service areas (an additional common characteristic) and the need for the same skill at delivering energy efficiently over longer distances for each service area (suggesting shared economies).[40]

It is important to remember that the corridor from Ohio to the Gulf of Mexico has historically been an important corridor for transportation and commerce. As discussed *infra,* an analysis of the various means of transportation in this corridor demonstrates that, in economic terms, the two parts of the merged company participate in a single economic region or market area.

The electric transmission and distribution industries located within the service territories of the merged AEP companies are not the only energy service providers that are located within what can be characterized as a "single area or region" within the meaning of 15 U.S.C. §79b(a)(29)(A). There are numerous other energy transmission service providers that likewise operate within the same or a substantially similar common energy transmission corridor, thereby further underscoring the existence of this single area or region.

The most notable example relates to the transmission and storage of natural gas. Specifically, Ohio is a state, like many others in the midwest and northeast regions of the United States, that is heavily dependent upon substantial imports of natural gas from other parts of the country to meet winter heating requirements for domestic and commercial uses, as well as for gas power generation. To obtain these required gas volumes, Ohio relies upon and is an integral part of an extensive network of high pressure, large diameter interstate pipelines that have been constructed over several decades to serve the gas utility distribution companies located in Ohio,

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[40] The ratios of 24.86 customers per mile of transmission or distribution line for AEP East and 21.98 customers per mile for AEP West are readily distinguishable from those for systems such as CenterPoint Energy, Inc. (340 cpm), The Southern Company (253.3 cpm), Entergy Corporation (116 cpm) and Exelon Corporation (671 cpm) that have service areas that more densely populated (or rely more heavily on transmission and distribution cooperatives). Favorable comparisons can also be made to systems such as Duke Energy (18.76 cpm) and Allegheny Energy (26.67 cpm) that serve relatively sparsely populated areas.

particularly in the peak winter heating season. These pipelines, as illustrated below, traverse a common energy pathway that exists from the primary gas producing fields located in the Texas area to these major consuming markets.

The U.S. Department of Energy has documented the existence of this comprehensive natural gas transmission corridor between Texas and Ohio, in a report issued in 1998 by the Energy Information Administration ("EIA"). As part of what it defines as the "Southwest-to-Midwest-corridor", the EIA identifies the six major interstate gas pipeline systems that transport large quantities of gas from the Southwest (which includes Texas) to the Midwest (which includes Ohio).[41] The Report also describes the existence of a "Southwest Panhandle-Midwest" pipeline corridor, in which four major natural gas pipeline companies operate, which commences in major natural gas producing fields located in the Texas panhandle and adjacent producing areas, and extends to the Midwest including Ohio. *Id.* at 42. As more fully detailed in the Report, the common area or region formed by these corridors is significant both in terms of ensuring that the energy needs of Ohio are met, but also serves as an essential gateway for further deliveries downstream to other consuming states in the Midwest and the northeastern region of the United States.

In that regard, the FERC has also recognized the existence of these energy corridors that exist to and through Ohio in order to serve as linkage points between gas "hubs", thereby facilitating the movement of these supplies to gas consuming areas both within and further downstream of Ohio. For example, in 1991 the FERC issued a certificate of public convenience and necessity authorizing ANR Pipeline Company ("ANR") and Trunkline Gas Company to expand their pipeline systems and operate a large new pipeline extension from the existing facilities of ANR to a delivery point at the facilities of Texas Eastern Gas Transmission Corporation near Lebanon, Ohio, thereby enhancing the ability of these pipeline systems to deliver incremental gas supplies into Ohio, as well as to markets further downstream in the Northeast.[42] Further, the FERC recently approved a proposed new pipeline project that was designed to source gas from a point of intersection with the pipeline facilities of ANR near Defiance, Ohio, and transport that gas to a gas hub in Pennsylvania, providing a link between the supply corridor already serving the Midwest and growing gas markets in the Northeast.[43] As these cases demonstrate, the common area or region illustrated by the well established Texas-to-Ohio natural gas transmission corridor is a vital component of the Nation's gas transmission and distribution infrastructure.

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[41] *See Deliverability on the Interstate Natural Gas Pipeline System*, Energy Information Administration, DOE/EIA-0618 (1998) at p. 41.

[42] *ANR Pipeline Company, et al.*, 54 FERC ¶61, 032 (1991).

[43] *See Independence Pipeline Co. et al.*, 89 FERC ¶ 61,283 at p. 61,837 (2000)The sponsors of Independence subsequently elected not to proceed with construction their project, for reasons unrelated to the existence of the energy corridor discussed herein.

River transportation also tends to demonstrate that the merged companies are in a "single area or region." In November, 2001, AEP acquired MEMCO Barge Lines, which are expected to move some 50 million tons of dry bulk commodities annually along the Ohio and lower Mississippi rivers and their tributaries, and along the Gulf Coast, including Texas.[44]

ii. Common Interconnection Region.

Another common characteristic of the area of operations of the merged AEP companies is that it is within the same electrical "interconnect." As a result of engineering developments and the construction of new transmission lines, in the United States today, the electric utility industry today is divided into three electricity "interconnects." As an engineering matter, within each of these "interconnects," electric power may readily be transmitted between and among all of the utilities operating in that area.

The United States Supreme Court, in its recent decision upholding FERC Order No. 888, noted that:

> unlike the local power networks of the past, electricity is now delivered over three major networks, or "grids" in the continental United States . . . . . [A]ny electricity that enters the grid immediately becomes a part of a vast pool of energy that is constantly moving in interstate commerce. As a result, it is now possible for power companies to transmit electric energy over long distances at a low cost.

New York v. FERC, __ U.S. ___, ___ (2002) (footnotes omitted). The Supreme Court thus recognized the very point that the Commission has emphasized in its prior cases, namely, technological developments extending the geographical range within which electric power may be physically transmitted are a relevant consideration in applying the "single area or region" test.[45]

These "interconnects" are significant, for present purposes, because they mean that different facilities located within an "interconnect," even if not contiguous or directly interconnected, are part of the same electric transmission system. As FERC has emphasized, through "interconnects," the "transmission facilities of any one utility in a region are part of a

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[44] Burlington Northern Santa Fe Railway and CSX Intermodal are providing new opportunities for rail transportation, connecting Texas and the Ohio Valley.

[45] As noted previously, in the *Connecticut Yankee Atomic Power Company* case, for example, the Commission emphasized the "existing state of the arts of generating and transmission" in finding that "each sponsor may be considered to operate in the same area or region." 41 S.E.C. 705, 710 (Nov. 15, 1963); *see also, e.g., Vermont Yankee Nuclear Power Corp.*, 43 S.E.C. 693 (Feb. 6, 1968) (same).

larger, integrated transmission system." In terms apt for the Commission's present purpose of determining whether AEP's operations are within a "single" area or region, FERC has emphasized that:

> From an electric engineering perspective, each of the three interconnections in the United States (the Eastern, the Western, and ERCOT) operates as a single machine.

Regional Transmission Organization, Notice of Proposed Rulemaking, IV FERC Stats. & Regs. ¶32,541 at 33,697.

AEP is concurrently seeking authority to enable it to comply with state-mandated restructuring in Ohio and Texas. *American Electric Power Co., Inc.* (SEC File No. 70-9785). As required by state law, AEP will begin to operate the Texas generation, and possibly the Ohio generation, separate and apart from the "primary" AEP system. All of AEP's non-ERCOT operations will be entirely within the Eastern Interconnect and so the Commission should find that they are confined to a "single area or region" for purposes of the Act. AEP believes that the Texas operations will comprise one or more permissible "additional systems" for purposes of the Act and so, on this basis alone, the Commission could find that the "single area or region" standard is satisfied.[46]

c. *The Area of the Merged System's First-Tier Interconnected Utilities Defines a Single Region in Which the Merged System Operates.*

The Commission has also defined relevant energy regions by application of the concept of the service areas of "first-tier utilities." The "first-tier utilities" are the merger applicants and all utilities interconnected with either merger applicant. While the Commission developed the approach of defining first-tier utilities as the merged company's region in the context of applying Section 10(b)(1) of the Act, which looks to the potential effects of a proposed merger on competition within the region, it is also relevant to applying the "single area or region" test under Section 10(c)(1). AEP submits that the service territories of the first-tier utilities interconnected with AEP and CSW constitute a "single area or region" in satisfaction of that test.

Section 10(b)(1) of the Act requires the Commission to examine whether a proposed acquisition "will tend towards . . . the concentration of control of public-utility companies, of a kind detrimental to the public interest or the interest of investors or consumers." The Commission has used its authority under Section 10(b)(1) to examine the effect of the size of the merged company, as well as the effects of the merger on competition. To analyze the

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[46] *See Reliant Energy, Incorporated*, Holding Co. Act Release No. 27548 (July 5, 2002) (finding that the restructured Texas electric operations would constitute two retainable systems for purposes of Section 11).

effect of the size of a merger under Section 10(b)(1), the Commission has examined, in particular, the size of the merged entity relative to its "region." This analysis requires identification of the relevant "region" with respect to each merger.

In its 1993 order approving Entergy Corporation's proposed acquisition of Gulf States Utilities, the Commission adopted and approved Entergy's proposal that the appropriate region for this 10(b)(1) test be defined by the first-tier interconnections of the merging companies (that is, the relevant region consisted of the Entergy and Gulf States operating territories, and all the utilities interconnected with either). Analyzing the competitive effects of the merger in light of this definition of the relevant region, the Commission found that the merger "would not significantly change the relationship between the size of the Entergy system and the rest of the electric utility industry in the region."[47]

In so holding, the Commission emphasized that under Section 10(b)(1), it is called upon to "'exercise its best judgment as to the maximum size of a holding company in a particular area, considering the state of the art and the area or region affected.'"[48] As this statement shows, this function is analogous to the nature of the Commission's inquiry in determining whether the system will operate in a "single area or region." While the ultimate goals of the two inquiries are different (in the first case to assess whether the merged company would unduly dominate business in the area or region affected, in the second to determine whether the merged company would operate in a single area or region), in both cases the Commission must decide how to delineate the "area or region" in which the merged company will operate. Indeed, the Commission has acknowledged that the inquiry under Section 10(b)(1) is related to the analysis of whether a utility is an "integrated public-utility system." In *Entergy*, the Commission cited Section 2(a)(29), the definition of an "integrated public-utility system," in support of the proposition that the Commission must "exercise its best judgment under Section 10(b)(1) as to the maximum size of a holding company in a particular area."[49]

It makes sense to apply the same standard for the single area or region test under Section 10(c)(1). Utilities operate in increasingly competitive and interconnected environment.

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[47] *Entergy* Corp., Holding Co. Act Release No. 25952 (Dec. 17, 1993), *request for reconsideration denied*, Holding Co. Act Release No. 26037 (Apr. 28, 1994), *remanded sub nom. Cajun Elec. Power Coop. Inc. v. SEC*, 1994 WL 704047 (D.C. Cir. Nov. 16, 1994), *on remand, Entergy Corp.*, Holding Co. Act Release No. 26410 (Nov. 17, 1995) (citations omitted). AEP and CSW also used the "first-tier utility" method to define the relevant region under Section 10(b)(1) in their application. The Commission found that the merger satisfied the requirements of Section 10(b)(1), and that finding was not challenged on appeal.

[48] *Entergy Corp.*, Holding Co. Act Release No. 25952 (Dec. 17, 1993) (quoting *Centerior Energy Corp.*, Holding Co. Act Release No. 24073 (Apr. 29, 1986)). *See also American Electric Power Company, Inc.*, 46 S.E.C. 1299, 1309 (1978).

[49] Holding Co. Act Release No. 25292 at n.34.

A determination of whether a merged utility will operate in a "single area or region" should begin with the recognition that the merger entity will not operate in isolation, but will interact with other utilities, particularly those that it can reach most economically – i.e., those with which it is directly interconnected. It is precisely for that reason that FERC looks at interconnected utilities as the most relevant markets for its horizontal antitrust analysis.[50] Likewise, this Commission should find that the merged utility meets the "single area or region" test if its sales and purchases are concentrated in a single contiguous area, including the service areas of its own operating companies and the service areas of interconnected utilities.[51]

Thus, it is useful to look to *Entergy's* recognition of the "first-tier utility" method as an acceptable way of defining the "region" for purposes of the Act's Section 10(b)(1) analysis, since the same concept is equally valid for purposes of applying the "single area or region" standard. Using this "first-tier utility" method of defining the relevant "region" as endorsed by the Commission in *Entergy*, AEP will demonstrate that the combined AEP system does operate in a single area or region.

Attachment A is a map showing of the first-tier utilities, which demonstrates that AEP and CSW are in a single region. The shaded area on the map forms a single seamless area, devoid of any constraints, bottlenecks or other attributes of uneconomical gerrymandering or "scatteration." As further indicated on the map, this area or region has a well-developed transmission system that interweaves and binds together this region and supports its function as an economic unit. This evidence shows, in sharp visual effect, that under the "first-tier utility" method as well, the area in which New AEP operates is confined to a "single area or region."[52]

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[50] FERC's guidelines for the review of electric utility mergers provide further support for this conclusion, suggesting independently the same concept of the bounds of the market likely to be affected by a merger. Informed by its expert knowledge of the current state of wholesale power markets in the United States, FERC requires that merger applicants submit a detailed quantitative analysis that covers the merging firms and all directly interconnected electric systems and service areas. *Revised Filing Requirements Under Part 33 of the Commission's Regulations*, Order No 642, 93 FERC ¶ 61,164 *mimeo* at 37 (2000). In reviewing the AEP-CSW merger, FERC found that the applicants' use of directly interconnected customers (and some historical customers) as relevant destination markets was in accordance with FERC's Merger Policy Statement). *See American Elec. Power Co. and Central and South West Corp.*, Opinion No. 442, 90 FERC ¶ 61,242 at 61,780 (2000), citing *Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement,* Order No. 592, III FERC Stats. & Regs. ¶ 31,044 at 30,119 (1996); *order on reconsideration,* Order No. 592-A, 79 FERC ¶ 61,321 (1997).

[51] Inevitably, some sales will be more than "one wheel" away from the utility. However, restricting the scope of the analysis of the single area or region" test to contiguous utilities is a more conservative approach in order to guard against potential "scatteration."

[52] This approach can also be used to addresses the question raised by the Court concerning the length of the contract path and the implications for "single area or region."

d. Common "Gravitational" Attraction.

Another methodology that may be used to assess whether an electric utility system will operate in a "single area or region" is a "gravity analysis," which is a general economic methodology used to measure the economic interaction between cities, states, or geographic regions. This is relevant because it used to determine whether two locations have a "gravitational" pull toward each other such that they should be deemed to operate within the same economic market. As such, it is another measure that can usefully provide a relevant common characteristic in applying the "single area or region" test.

AEP has commissioned Dr. Charles J. Cicchetti to perform a gravity model analysis on the relationship between the former AEP and CSW entities, and will put the results of his analysis into the record. This analysis will illustrate that, in economic terms, the two parts of the merged company participate in a single economic region or market area. The gravity model measures the economic "pull" between geographically separate locations as a function of the economic size or "mass" of each location and the distance between them. Thus, this method quantifies the economic connections and ties between geographically separated economic entities, such as metropolitan areas and states. The model uses factors such as commodity flows from location to location; total personal income of each location; population of each location; employment of each location; and distance between the two locations.

With respect to commodity flows, for example, the gravity analysis looks to the percent of commodity shipments going "to or from" the various economic entities from within the geographic area as compared to entities from outside. A relatively self-contained geographic area is one in which relatively more commodities are generated within the economic region. Specifically, the greater the percent of goods (tons or dollar valued) that are produced, shipped and used locally, the more likely the geographic area is a relatively self-contained and identifiable, comprehensive economic market or region.

In this case, Dr. Cicchetti has applied the "gravity" analysis to estimate the potential economic interaction or pull between the sub-regions served by the former AEP and CSW systems, and to determine whether these specific markets are part of a larger single economic region. Dr. Cicchetti's analysis shows that AEP and CSW are, in fact, within a single economic region using these common characteristics. *See* Attachment B (diagram illustrating Dr. Cicchetti's results).

Conclusion

The Court has cautioned that the Commission cannot "read out of the statute" the "single area or region" requirement. To that end, any finding which merely says that the entire country is a single region seems unlikely to survive judicial review. Nor can engineering capability alone or the scope of feasible open access transmission in and of itself define an appropriate region. As the Court noted, "Technological improvements may well justify ever-expanding electric utilities, but PUHCA confines such utilities to a 'single' area or region."

NRECA v. SEC, 276 F.3d at 618. These factors, however, together with the others discussed in this memorandum, do compellingly establish that the various parts of the AEP system bear a rational relationship to one another and so are confined to a "single area or region" within the meaning of the Act.[53]

We would be happy to discuss with you the approach we are proposing with respect to the AEP remand proceedings.

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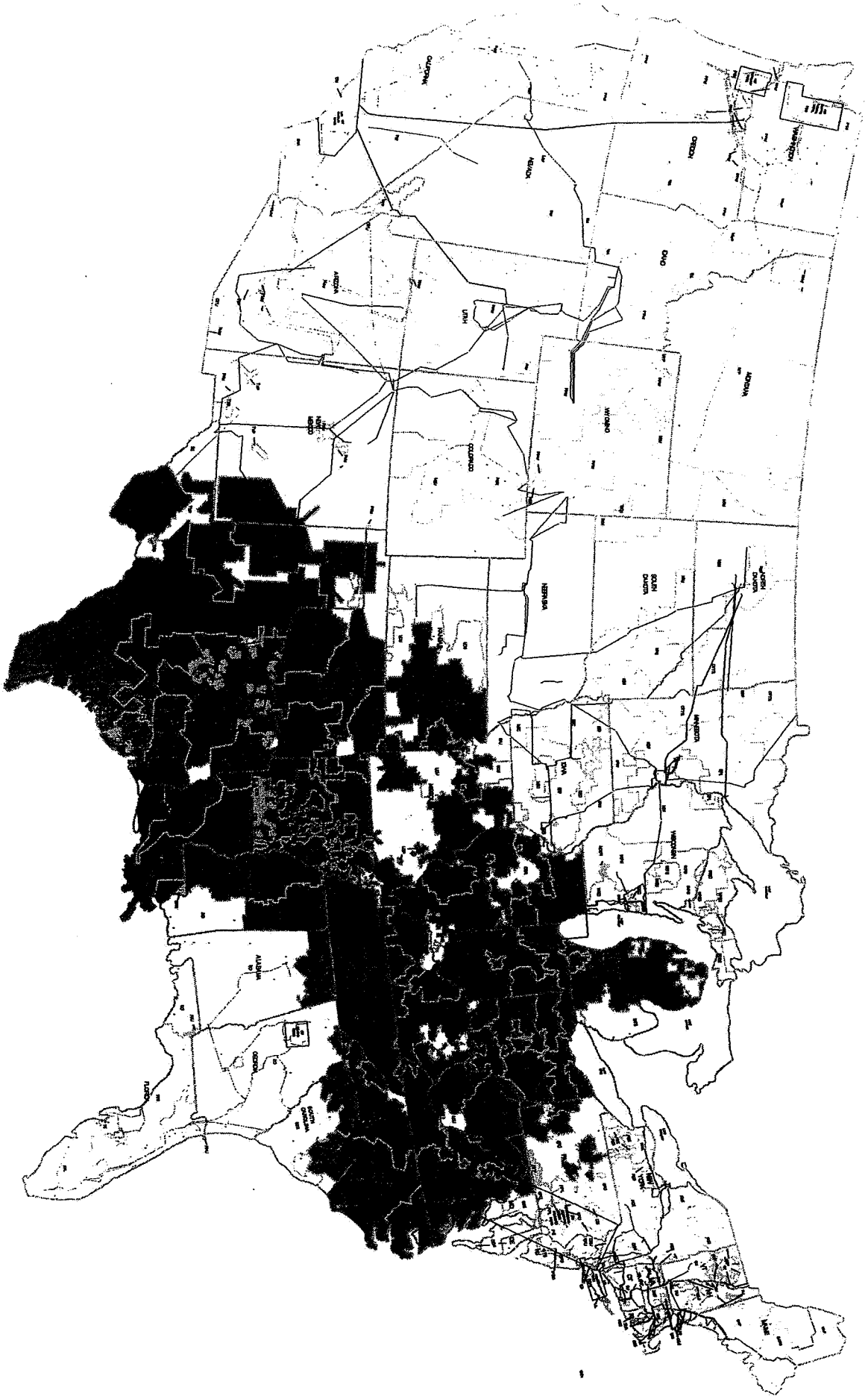
[53] As one commentator has explained:

> In particular, the SEC tried to say in the *AEP Order* that a new holding company system that could operate in an efficient and coordinated manner, and which did not impair local management and control or undermine state regulation, should be viewed as beneficial under national energy policy. The single region requirement of PUHCA was primarily designed to facilitate exactly those goals. This policy would hold that a utility holding company system operates in a single region if its parts bear a rational relationship to one another and produce increased economies and efficiencies in the operation of its system.

William J. Harmon, *More Uncertainty for Utility M&A: DC Circuit Rejects SEC Approval of American Electric Power – Central and South West Corp*, 28 Energy Bulletin (Jan. 2002).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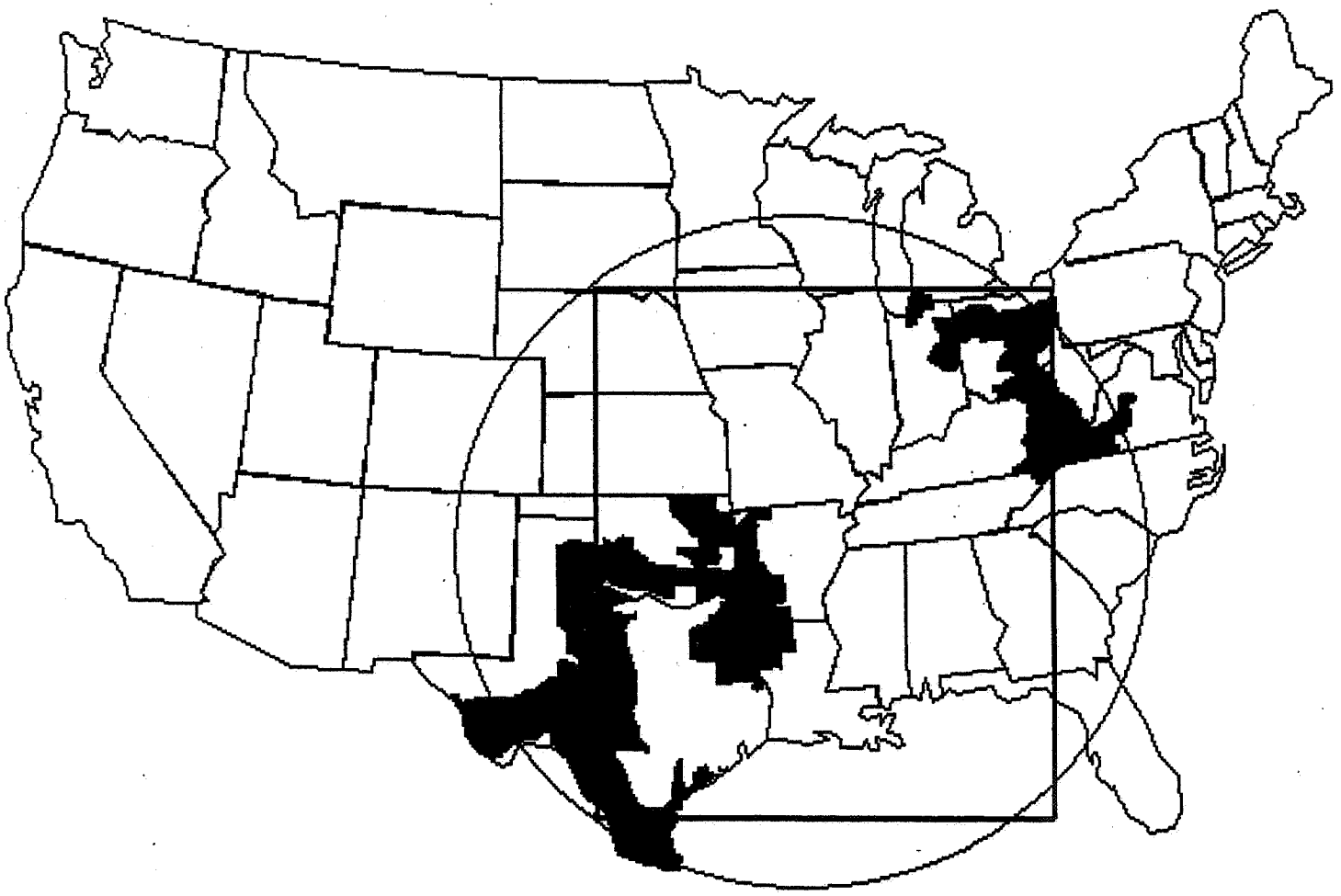

1. The shaded area represents the service territory of The Merged Utility.
2. The Rectangular and Circular Territories are discussed in the text and in the tables in this exhibit.